Internal Revenue Service

memorandum

CC:TL:TS
HELKE/alb

date: JUN 21 1987

to: District Counsel, New Orleans SE:NO

from: Director, Tax Litigation Division CC:TL

subject: Request for Technical Advice [redacted]

ISSUES

1. Whether the additions to tax under I.R.C. §§ 6653(a)(1), 6653(a)(2), and 6659 and the increased interest provision of section 6621(c) are applicable where the petitioners contend in the Tax Court they are entitled to an overpayment of tax pursuant to their Form 1040X, when the refund claimed per said return was frozen by the Internal Revenue Service.

2. Whether the frozen refund claimed by petitioners pursuant to a Form 1040X should be treated as a rebate for purposes of computing the underpayment of tax in applying the additions to tax under I.R.C. §§ 6653(a)(1), 6653(a)(2) and 6659, as well as section 6621(c).

CONCLUSION

Under the facts in this case, the penalties and additional interest as set forth above should be asserted against the taxpayer whose refund claim on Form 1040X was "frozen" by the Service. Further, the amount of the frozen refund claimed constitutes a rebate for the purposes of computing the underpayment of tax.

Facts:

In [redacted], the petitioners entered into a lease agreement with [redacted], a division of [redacted]. The petitioners received an investment tax credit pass-through from [redacted] in the amount of $[redacted] which related to the value of an audio master recording which was the subject of the lease. In their [redacted] return, the petitioners claimed an investment tax credit relating to the master recording in the amount of $[redacted]. In addition, the petitioners also claimed Schedule C expenses involving the master recording in the amount of $[redacted] which were computed by amortizing the lease payment and

a distribution agreement payment over the [redacted] year life of the lease. The petitioners were unable to use all of the claimed investment tax credit in [redacted] and they filed amended U.S. Individual Income Tax Returns for [redacted], [redacted], and [redacted].

In [redacted], the Service received the petitioners' Form 1040X for the taxable year [redacted] which claimed an investment tax credit carryback from [redacted] to [redacted]. The petitioners claimed a refund which was never refunded by the Service, nor was this amount used to decrease the petitioners' tax liability as claimed on the amended income tax return. On [redacted], a notice of deficiency was issued to the petitioners for the taxable years [redacted] and [redacted]. In addition to the deficiencies set forth, the notice of deficiency also asserted the additions to tax under sections 6653(a)(1), 6653(a)(2), 6659 and the applicability of section 6621(c) was also raised. The notice of deficiency for [redacted] disregarded the petitioners' amended tax return and was computed without regard to investment tax credit carryback.

In [redacted], the petitioners filed a petition in the Tax Court in which they alleged that they were entitled to an overpayment for the taxable year [redacted] in the amount based upon the amended tax return which claimed the investment tax credit carryback relating to [redacted].

Law and Analysis:

Section 6621(c) provides for additional interest to be payable with respect to any substantial underpayment attributable to tax motivated transactions.

Section 6653(a) provides for an addition to tax for negligence in an amount equal to 5 percent of the underpayment.

Section 6659(a) provides that if an individual has an underpayment of tax for a taxable year which is attributable to a valuation overstatement, there shall be added to the tax an additional amount as computed under 6659(b). An underpayment of tax is a prerequisite for application of this provision and is defined with reference to section 6653(c)(1). I.R.C. § 6659(g).

Section 6653(c)(1) provides that the term underpayment for income tax purposes means a deficiency as defined in section 6211, except that the tax shown on the return (referred to in section 6211(a)(1)(A)) shall be taken into account only if such return was filed on or before the due date prescribed for filing (with regard to extensions). Treas. Reg. § 301.6653-1(c) defines an underpayment as the total amount of all deficiencies as defined in section 6211, if a return was timely filed, or, if a return was not timely filed, the amount of income, estate or gift tax imposed.

Section 6211(a) defines a deficiency as the amount by which the tax imposed exceeds the excess of (1) the sum of the tax shown on the taxpayer's return, plus amounts previously assessed (or collected without assessment) as a deficiency, over (2) the amount of any rebates. The Tax Court, in Kurtzon v. Commissioner, 17 T.C. 1542 (1952), has reduced the definition of a deficiency to the following mathematical formula:

Deficiency = Correct tax - (tax on return + prior assessments - rebates).

With respect to the question of what constitutes a rebate for purposes of computing a deficiency under section 6211(a), section 6211(b)(2) defines a rebate as so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed was less than the excess of the amount shown on the return (plus amounts previously assessed as deficiencies) over rebates previously made. Thus, where the tax due is less than the tax shown on the return and a refund is made to the taxpayer of the excess amount, such a refund would be considered a rebate under section 6211. See, Treas. Reg. § 301.6211-1(a) and (f).

Also, the Interpretative Division has previously considered the question of whether a section 6411 tentative carryback and refund adjustment should be considered a rebate for purposes of calculating the amount of a deficiency under section 6211. See, O.M. 19801, [redacted] - Definition of Deficiency Under I.R.C. § 6211, April 13, 1984. In O.M. 19801 the Interpretative Division concluded that a tentative refund made to a taxpayer should be included in the calculation of the deficiency as a rebate even though a determination had not been made concerning the propriety of issuing the refund. In the [redacted] case, a tentative refund was made to the taxpayer and the Service assessed a deficiency for the carryback year; however, the Service had not made a determination concerning the issuance of the refund. Nevertheless, the conclusion was reached that the tentative refund amount should be treated as a rebate. O.M. 19801 relied heavily upon the Tax Court's opinion in Pesch v. Commissioner, 78 T.C. 100 (1982). In Pesch, the Service made the determination that the taxpayer was not entitled to the refund attributable to a tentative carryback of a net operating loss and issued a statutory notice of deficiency. The Court concluded that the tentative refund amount should be treated as a rebate for purposes of computing a deficiency under section 6211. As O.M. 19801 correctly pointed out, the tentative refund in the Pesch situation had to be treated as a rebate for a deficiency to exist within the meaning of section 6211(a).

The only difference between the Pesch situation and the instant facts is that it addressed a tentative refund and here the refund claimed on Form 1040X was never actually paid to the taxpayer and the deficiency procedures were not invoked.

Section 6661 provides that if there is a substantial understatement of tax for a taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement.

Section 6661(b)(2) defines understatement as the amount of tax required to be shown on the return less the amount of tax shown on the return, reduced by any rebate (as defined in section 6211(b)(2)). Section 1.6661-2(d) of the regulations indicates that the computation of the amount shown on the return is made without regard to carryback items but with regard to rebates. Section 6661(b)(3) and section 1.6661-2(f) of the regulations provide the manner in which section 6661 is coordinated with section 6659.

Sections 6659 and 6661 are analogous in application to section 6653. Section 6653 provides for additions to tax where there is an underpayment of tax due to fraud or negligence. Sections 6659 and 6661 provide for additions to tax where there is an underpayment due to a valuation overstatement or substantial understatement in tax, respectively. Also, the definitions of the term underpayment for purposes of section 6653 and section 6659 are the same. Accordingly, sections 6659 and 6661 would be applicable to any underpayment or understatement resulting from a refund generated by Form 1040X to the same extent section 6653 would apply to any resulting underpayment.

I. Tentative Carryback Adjustment Provisions and Deficiency Procedures:

Section 6411 generally provides a quick refund procedure for carryback adjustments attributable to certain items.

Section 6411(b) provides that the Secretary may conduct a limited review of the application for tentative carryback refund (for omissions and errors in computation) within a 90 day period and permits the Secretary to take certain action with respect to the application when such errors are discovered. Treas. Reg. § 1.6411-3.

Section 6213(a) provides that no assessment of a deficiency and no levy or proceeding in court for its collection will be made, begun or prosecuted until a notice of deficiency has been mailed. However, under section 6213(b)(3), if the Secretary determines that the amount applied, credited or refunded under section 6411 is in excess of the overassessment attributable to the carryback, the Secretary may assess the amount of the excess as a

deficiency as if it were due to a mathematical or clerical error appearing on the return. This provision restores both the Secretary and the taxpayer to the position occupied prior to the approval of the application for tentative carryback adjustment. See, Rev. Rul. 84-175, 1984-2 C.B. 296. Under this section, no notice of deficiency need be issued to the taxpayer, and the taxpayer has no right to file a petition in the Tax Court. Instead, the taxpayer can file a regular claim for refund based on the carryback adjustments and maintain a refund suit if such claim is disallowed by the Secretary. Treas. Reg. § 301.6213-1(b)(2).

For purposes of the refund freeze program, a determination that it is highly likely that there is (1) a gross valuation overstatement or (2) a false or fraudulent statement with respect to the tax shelter entity or arrangement that would be subject to a penalty under section 6700, will provide a sufficient basis for an assessment of the portion of the refund attributable to the abusive shelter. Rev. Proc. 84-84, 1984-2 C.B. 782; Rev. Rul. 84-175, supra.

II Applicable Revenue Rulings

Rev. Rul. 60-215, 1960-1 C.B. 642, addressed the application of the 50 percent fraud penalty imposed by section 6653(b) to a deficiency assessed to recover an erroneous allowance of a tentative carryback adjustment under section 6411. The revenue ruling held that the fraud penalty applied to the deficiency relative to the carryback year. The reasoning behind this holding was simply that penalties are to be asserted in accordance with the nature of the infraction set out in the statute. Accordingly, once it has been determined that there is a deficiency (underpayment) due to fraud, the 50 percent penalty should be applied. This same reasoning would apply with respect to sections 6659 and 6661 which are analogous in their application to section 6653.

Additionally, this revenue ruling contains a deficiency calculation for the carryback year which is instructive on the question concerning the effect of the tentative carryback adjustment on the deficiency amount. The facts of the revenue ruling are as follows:

> A taxpayer filed an income tax return for the year 1955 disclosing a Federal tax liability of 306x dollars for the taxable year, which was paid. On the return for the year 1957, the taxpayer reported a loss of 184x dollars. Immediately thereafter, the taxpayer made application for a tentative carryback adjustment for the year 1955 under section 6411 of the Code. As a result, tax in the amount of 95x dollars for the year 1955 was refunded as a tentative allowance. Following an examination of the taxpayer's returns for the years

> 1955, 1956, and 1957, a further tax liability was disclosed and the taxpayer paid additional tax of 5x dollars for the year 1955. Upon further examination of the taxpayer's returns, it was determined that the carryback allowance was induced by fraud and that the correct amount of tax for the year 1955 should be 372x dollars.

The deficiency with respect to the carryback year was computed as follows:

> Deficiency = $372, correct tax - ($306, tax on return + $5, prior assessment - $95, rebates) = $156.

It should be noted that the tax shown on the return, for purposes of the above computation, was the tax shown on the originally filed 1955 tax return; the tentative refund amount was not reflected as a previously assessed amount; and the amount of the tentative refund was reflected as a rebate. This approach is consistent with O.M. 19801 and the Pesch decision. See, Pesch v. Commissioner, supra at 111.

Rev. Rul. 84-106, 1984-2 C.B. 312, followed Rev. Rul. 60-215, supra, in applying the negligence penalty to a deficiency resulting from a tentative refund attributable to a prior year. The facts of this ruling are as follows:

> X timely filed a federal income tax return for 1978 showing a tax liability of $100, which X paid. When the return was later examined, the Internal Revenue Service asserted a deficiency of $100, which X paid. X later reported a loss on its 1981 income tax return and under section 6411 of the Code carried the loss back to 1978. As a result, X was refunded a tentative allowance of $200. When the Service later examined X's 1981 return, it determined that X did not have a loss for 1981. The Service also determined that the addition to the tax for negligence under section 6653(a) was applicable.

Relying on Rev. Rul. 60-215, and Rev. Rul. 55-173, 1953-2 C.B. 227, this ruling applied the negligence penalty to the resulting deficiency which was determined as follows:

> Deficiency = $200, correct tax - ($100, tax on return + $100, prior assessment - $200, rebate) = $200.

Again, the tentative refund was considered a rebate and was not used as an adjustment to the tax figure shown on the return filed in the carryback year.

Finally, Rev. Rul. 81-311, 1981-2 C.B. 246, provides that in applying the negligence penalty, the combined penalty and tax assessment may exceed the amount that had been previously refunded as a result of a tentative carryback adjustment.

III Application of Above Provisions

The Service may summarily assess a deficiency attributable to a tentative carryback adjustment as if due to a mathematical or clerical error, pursuant to section 6213(b)(3).

Under the above Code sections and revenue rulings, once a deficiency/underpayment with respect to the carryback year is determined, the Service could technically assert the section 6659 penalty in accordance with the percentage formula set out in section 6659(b).

In the instant case, the Service properly scheduled the refund for payment and then "froze" the refund. The amount the Service should have refunded would constitute a rebate under O.M. 19801 and Pesch. The mere fact that the refund was never paid is a distinction without a difference for purposes of computing the deficiency under section 6211. 1/

With respect to each of the other elements of the statutory deficiency formula, the following would apply under the specific facts of your case:

1. "Tax imposed" - The tax imposed in the carryback year under the instant facts would be the amount reflected on the taxpayer's original return unreduced by any carryback items reflected on the Form 1040X. I.R.C. § 6211(a).

2. "Amount shown as the tax" - Amount shown as tax by the taxpayer would be determined with reference to the original filed return, without regard to any carryback items reflected on Form 1040X. I.R.C. § 6211(a)(1)(A).

3. "Amount previously assessed as a deficiency" - In this instance, no amount was previously assessed. The amount assessed under 6213(b)(3) would not constitute a previous assessment under this section. I.R.C. § 6211(a)(1)(B).

1/ As we have previously stated, the Service has three ways to recover refunds allowed under section 6411. It may resort to deficiency procedures, bring a civil action to recover an erroneous refund, or assess a deficiency under the procedures set out in section 6213(b)(3). While the choice of alternative recovery methods will impact on the taxpayer's procedural rights, the Service's decision to use one method over another should not alter the way in which the deficiency is ultimately computed. See, Pesch v. Commissioner, supra at 118, indicating that the selection of a particular remedy to recoup an erroneous refund under section 6411 is within the Service's discretion.

Accordingly, the computation of the 1983 deficiency under section 6211 and Kurtzon would be as follows:

Deficiency = $200, correct tax - ($200, tax on return + $0, prior assessment - $50, rebates) = $50.

Since an underpayment of $50 exists with respect to the carryback year, the section 6659 penalty could be applied if the underpayment was due to a valuation overstatement.

The same reasoning would apply to the application of the section 6661 penalty. To the extent a substantial understatement of income tax exists relative to the carryback year, the penalty could technically be applied.

To determine whether an understatement exists within the meaning of section 6661(b)(2), the following formula applies:

Understatement = $200, correct tax - ($200, tax shown on the return - $50, rebates) = $50.

If the understatement is "substantial" within the meaning of section 6661(b)(1), the understatement penalty can be applied consistent with section 6661(b)(3). The computation of the understatement for purposes of section 6661 differs from the calculation of an underpayment under section 6659 in that it does not take into account amounts previously assessed as deficiencies.

We have had extensive discussions with Kathy Lier concerning this technical advice. We note that even though the analysis above deals primarily with a quickie refund under section 6411, there is really no substantive difference between a quickie refund and a refund generated by Form 1040X. The Service could have issued the refund claimed by the Form 1040X and then immediately moved to assess and collect. Under those circumstances, the Service could have assessed the appropriate additions to tax.

In a Litigation Guideline Memorandum dated February 6, 1987, concerning the assertion of the sections 6659 and 6661 penalties against the taxpayer for carryback years where the taxpayers' tentative allowance for refund had been withheld under the Service's refund freeze program, the conclusion stated:

> The position of the Tax Litigation Division is that the sections 6659 and 6661 penalties should not generally be asserted against the taxpayer for carryback years in situations where a taxpayer's tentative refund has been withheld and offset against an assessment as part of the refund freeze procedure. If, however, the taxpayer either prosecutes a refund action, claims an overpayment in Tax Court or defends against the deficiency on

the ground that he is entitled to the benefits of the shelter, assertion of the penalty is appropriate.

Accordingly, the petitioners in this proceeding are claiming an overpayment in the taxable year [redacted] based upon [redacted] tax shelter scheme. The refund they requested for an amended [redacted] income tax return was frozen. The logic behind the LGM's conclusion was that the Service had the money and, therefore, there was no need to further penalize a taxpayer unless the taxpayer persisted in its court action. Under your particular facts, the taxpayer has persisted, and accordingly the penalties and additional interest are properly assessed.

If you have any questions, please contact Joel Helke on FTS 566-4369.

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